

Message Text

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ACTION EUR-25

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TO SECSTATE WASHDC 4151

INFO AMEMBASSY BONN

AMEMBASSY PARIS

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION OECD PARIS

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C O N F I D E N T I A L SECTION 1 OF 2 LONDON 12356

DEPARTMENT PASS TREASURY AND FRB

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: UK ECONOMIC PROSPECTS AFTER THE ELECTION

SUMMARY: THE UK ELECTION CAMPAIGN WILL BE FOUGHT LARGELY ON ECONOMIC GROUNDS. WHICHEVER PARTY WINS WILL BE FACED IMMEDIATELY WITH PROBLEMS OF RISING INFLATION AND UNEMPLOYMENT; WEAK BUSINESS CONFIDENCE AND REDUCED MANUFACTURING INVESTMENT STEMMING IN PART FROM DECLINING PROFITS, AND SLACK DOMESTIC DEMAND; AND THE NEED INTERNATIONALLY TO SHOW CONTINUING IMPROVEMENT IN THE NONOIL TRADE DEFICIT IN ORDER TO MAINTAIN CONFIDENCE IN STERLING. THIS MESSAGE HIGHLIGHTS SOME OF THE MORE PRESSING ECONOMIC DIFFICULTIES, INCLUDING NEAR TERM BALANCE OF PAYMENTS CONSIDERATIONS, THAT WILL FACE THE NEXT GOVERNMENT, WHATEVER ITS COMPOSITION. END SUMMARY

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1. THE COUNTRY HAS ENTERED AN ELECTION PERIOD. AT THIS WRITING, THREE OF THE FOUR MAJOR PUBLIC OPINION POLLS INDICATE THE LABOUR PARTY IS PULLING AHEAD. THE REMAINING POLL SHOWS THE CONSERVATIVES WITH A SLIGHT LEAD. A LARGE PORTION OF THE ELECTORATE REMAINS UNDECIDED. A KEY QUESTION IS WHETHER LABOUR WILL WIN ENOUGH VOTES TO FORM A VIABLE MAJORITY GOVERNMENT OR, FAILING THIS, IF THE CONSERVATIVES WILL BE ABLE TO INDUCE THE LIBERALS TO FORM A RULING COALITION.
2. SOME OBSERVERS IN INDUSTRY AND THE CITY BELIEVE THAT IF LABOUR WINS, THE RESULT WILL BE A WAGE EXPLOSION AS THE "SOCIAL CONTRACT" IS PROGRESSIVELY AND QUICKLY ERODED, A DETERIORATION IN THE NONOIL TRADE ACCOUNT BEGINNING IN MID TO LATE 1975 AS THE COST-PUSH EFFECTS HIT BOTH DOMESTIC AND EXPORT PRICES, A POSSIBLE RUN ON STERLING, AND REIMPOSITION OF A TOUGH STATUTORY INCOMES POLICY. IF, TO THE SURPRISE OF MOST, THE "SOCIAL CONTRACT" IS RESPECTED AND THE TRADE UNIONS DO EXERCISE RESTRAINT, THE OUTLOOK WOULD BE MORE OPTIMISTIC.
3. A POSSIBLE RESULT OF A CONSERVATIVE VICTORY WOULD BE RENEWED INDUSTRIAL UNREST AS EFFORTS WERE MADE TO REIMPOSE AN ELEMENT OF DISCIPLINE AND RESTRAINT ON THE TRADE UNIONS, WHICH UNDER LABOUR HAVE GENERALLY HAD THEIR OWN WAY.
4. THE OUTCOME OF THIS ELECTION WILL HAVE A KEY DETERMINATION ON BRITISH ECONOMIC POLICY AND INDUSTRIAL STRUCTURE FOR SOME YEARS TO COME, WITH THE DEGREE OF NATIONALIZATION AND STATE CONTROL OF INDUSTRY BEING A MAJOR ISSUE. IN THE SHORT RUN, HOWEVER, BETWEEN NOW AND THE END OF THE YEAR, THERE IS LITTLE THAT ANY PARTY CAN DO THAT WILL HAVE AN IMMEDIATE IMPACT ON THE PROBLEMS FACING THE UK ECONOMY.
5. THE GROWTH OF GROSS DOMESTIC PRODUCT THIS YEAR OVER 1973 MAY BE NEGATIVE, FROM MINUS 0.5 TO MINUS 1 PERCENT. IN PRIVATE CONVERSATIONS, UK OFFICIALS EXPECT POOR DOMESTIC ECONOMIC PERFORMANCE IN 1975; GROWTH IN THE RANGE OF ONE PERCENT SEEMS LIKELY. (SEE LONDON A-745.) IF LABOUR WINS, A NOVEMBER BUDGET CAN BE EXPECTED TO INTRODUCE RE-

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FLATIONARY MEASURES ON A SELECTIVE BASIS, INCLUDING SOME SIMED AT INCREASING INDUSTRIAL INVESTMENT AND PRODUCTIVITY. STEPS WILL BE TAKEN TO INCREASE CASH FLOW AND PROFITS, CURRENTLY RESTRAINED BY THE PRICE CODE. TRANSFER PAYMENTS COULD BE INCREASED. THE CONSERVATIVES WOULD PROBABLY MAKE SIMILAR MOVES. EITHER PARTY RETURNED TO POWER WILL BE TEMPTED TO REINTRODUCE A STATUTORY WAGE POLICY IF THE UNIONS MAKE INFLATIONARY WAGE DEMANDS.

6. TO THE EXTENT THAT THE BRITISH ECONOMY DOES NOT PROVIDE SUFFICIENT DEMAND FOR BRITISH INDUSTRIAL CAPACITY, BRITISH COMPANIES CAN BE EXPECTED TO PROMOTE MORE VIGOROUS EXPORT POLICIES. THEY ALREADY HAVE BEEN TAKING A MORE ACTIVE INTEREST IN EXPORTS MARKETS AS A RESULT OF PRICE CODE LIMITATIONS ON DOMESTIC PROFITS. THERE WILL LIKELY BE PRESSURE ON THE NEXT GOVERNMENT FROM INDUSTRY AND THE LABOR UNIONS TO INFORMALLY ENCOURAGE "BUY BRITISH" POLICIES WHEREVER POSSIBLE. IN PRIVATE CONVERSATIONS UK OFFICIALS STRESS THAT THEY WILL CONTINUE TO TAKE A HARD LINE AGAINST TRADE RESTRICTIONS; THEY HAVE CONVINCED THE CURRENT CHANCELLOR OF THE DANGERS INVOLVED.

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7. IN ALL LIKELIHOOD, THE SHARP IMPROVEMENT IN THE AUGUST TRADE FIGURES WILL NOT CONTINUE, OR EVEN REMAIN (A REDUCTION FROM A MONTHLY AVERAGE DEFICIT OF 477 MILLION POUNDS IN MAY-JULY TO 319 MILLION POUNDS IN AUGUST). THE IMPROVEMENT REFLECTS IN A PART A DECLINE IN INVENTORY ACCUMULA-

TION, REDUCED CRUDE OIL SHIPMENTS, AND NEW REFINERY CAPACITY. MONTHLY TRADE DEFICITS AVERAGING AT LEAST 400 MILLION POUNDS ARE PROBABLE FOR THE REST OF THE YEAR. THE TRADE DEFICIT ALREADY TOTALS 3452 MILLION POUNDS FOR THE FIRST EIGHT MONTHS. IN 1974, THERE WILL BE AN ANNUAL TRADE DEFICIT IN THE RANGE OF 5.2 BILLION, OFFSET BY AN INVISIBLES SURPLUS OF 1.25 BILLION POUNDS, YIELDING A CURRENT DEFICIT OF 3.95 TO 4.0 BILLION POUNDS FOR THE YEAR. THE ESTIMATED CURRENT DEFICITS ARE 9.5 BILLION DOLLARS IN 1974 AND 7 BILLION DOLLARS IN 1975, GIVEN EXISTING TRENDS.

8. FINANCING THE CURRENT DEFICIT HAS NOT BEEN A PROBLEM, AT LEAST NOT THIS YEAR. THE SECOND QUARTER CURRENT AC-
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COUNT DEFICIT OF 1024 MILLION POUNDS WAS MORE THAN OFFSET BY IDENTIFIED CAPITAL INFLOWS OF 1130 MILLION POUNDS AND POSITIVE ERRORS AND OMISSIONS OF 34 MILLION POUNDS; 111 MILLION POUNDS WERE ADDED TO OFFICIAL RESERVES. (SEE LONDON A-748.) THE 2.5 BILLION DOLLARS EURODOLLAR BORROWING IN MARCH STILL HAS NOT BEEN DRAWN ON.

9. LOOKING AHEAD, UK BALANCE OF PAYMENTS FORECASTERS ARE GENERALLY OPTIMISTIC ABOUT CONTINUING IMPROVEMENT ON THE NONOIL TRADE ACCOUNT DURING THE NEXT NINE MONTHS. THEY CITE IMPROVED TERMS OF TRADE, A GOOD BACKLOG OF EXPORT ORDERS, SLACK DOMESTIC DEMAND, AND NONOIL PRIMARY PRICES STABILIZING OR DECLINING. CONTINUED GOOD NONOIL TRADE ACCOUNT PERFORMANCE APPEARS "BUILT IN" FOR THE COMING MONTHS.

10. BEYOND MID-QUOT HOWEVER, THE SITUATION IS LESS OPTIMISTIC. INITIALLY, RISING UK EXPORT PRICES REFLECTED WIDER PROFIT MARGINS. INCREASINGLY, THEY REFLECT HIGHER COSTS, AND MANY UK EXPORTS ARE SEEN AS LOSING THEIR COMPETITIVE ADVANTAGE, A TREND THAT WILL CONTINUE GIVEN DOMESTIC COST PRESSURES. UK FORECASTERS EXPECT A WORLD SLUMP IN 1975, WITH WORLD TRADE INCREASING ABOUT 5 PERCENT. TAKING THESE FACTORS INTO ACCOUNT, AND GIVEN TIME LAGS, THEY SEE POOR EXPORT PERFORMANCE IN 1976. INTEREST PAYMENTS WILL ALSO BITE HEAVILY INTO THE TRADITIONAL INVISIBLES SURPLUS, ALTHOUGH OVERALL UK INVISIBLES PERFORMANCE HAS OFTEN APPEARED STRONGER IN RECESSIONS (BECAUSE OF REDUCED REMITTANCES OF FOREIGN CORPORATIONS, REDUCED FOREIGN HOLIDAYS, ETC.)

11. POSITIVE CAPITAL FLOWS SHOULD CONTINUE, GIVEN REASONABLE GOVERNMENT INDUSTRIAL POLICIES AND BARRING THE ALWAYS POSSIBLE EVENTUALITY OF A RUN ON STERLING. MAJOR BANKS HERE DO NOT FORESEE SUCH A RUN, BUT ARE FOLLOWING "PRUDENT"

POLICIES -- THEY ARE NOT LONG ON STERLING. WEALTHY AND
MIDDLE CLASS PRIVATE INDIVIDUALS WILL CONTINUE TO SEEK
WAYS OF GETTING FUNDS OUT OF ENGLAND PRIOR TO THE PASSAGE
AND IMPLEMENTATION OF THE LABOUR PARTY'S GIFT AND WEALTH
TAX LEGISLATION. THIS IS ONE REASON FOR THE CURRENT
HIGH LEVEL OF INVESTMENT DOLLAR PREMIUM (ABOUT 60 PERCENT).
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THERE COULD WELL BE A FURTHER DECLINE IN THE POUND AGAINST
THE DOLLAR IN COMING MONTHS.
ANNENBERG

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